Investment Strategy Weekly

OAK ASSOCIATES, *ltd.*

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BULL FIGHT

Savvy old-timers say "Don't fight the Fed!" In other words, don't own stocks when the Federal Reserve is raising interest rates. During the inflation-challenged 1960s, 1970s, and 1980s, the S&P 500 peaked a few months after the trough in the fed funds rate. Following the February 1994 initial cyclical rate hike, the market stalled for 11 months, but then it soared over the rest of the decade. The late-1999 rate hike was followed by a crash. So far the S&P 500 is up, but only 3% since the Fed started raising the fed funds rate 10 months ago on June 30, 2004 (Figures 1 and 2). So which will it be: Is the bull finally starting to lose his fight with the Fed or will he soon charge again?

When To Hold 'Em And When To Fold 'Em. I continue to place my bets on the bull. In other words, I still believe that the 1990s Replay Scenario is the best script for the way this decade is playing out. There is no foreseeable reflation, stagflation, deflation, or recession in my outlook. While I certainly do respect time-tested adages like "Don't fight the Fed," they should be updated to reflect the current situation. Today, it should be "Don't fight the Fed if the Fed is fighting a serious inflation problem." The latest minutes of the March 22 Federal Open Market Committee (FOMC) suggests that the Fed is prepared to fight inflation, if necessary, but it might not be necessary.

Greg Ip, who follows the Fed for *The Wall Street Journal*, had a more bearish interpretation in his April 13 article about the minutes: "Signaling a more hawkish stance toward inflation, the Federal Reserve expects to raise interest rates higher than it previously believed necessary and possibly at a faster pace, minutes to its March 22 policy meeting suggest." Greg should know. He is very well connected at the Fed and often is used by Fed officials to prep the markets for policy changes. On the other hand, as Greg also reported, "Stock and bond investors had worried the minutes might point to an even more aggressive stance on the part of the Fed, and markets reacted with relief."

In my opinion, the markets reacted well because the minutes indicated that the members of the FOMC are talking tough about a possible inflation problem, but they are not sure that it is a serious enough problem to warrant fighting it any harder than they have been. Of course, there is a paragraph in the minutes about the risks that inflation might take off. But it was balanced with the following paragraph, which I am reprinting here because it happens to coincide with my views on this subject:

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> Meeting participants commented in particular detail on the inflation situation. They noted with some concern the recent elevated readings on inflation in prices of core personal consumption expenditures, the producer price index, and indicators of prices at earlier stages of production, as well as the sizable further increase in energy prices. Nonetheless, many participants stated that they expected total inflation to diminish and any rise in core consumer inflation to be limited. One source of upward pressure on inflation had been the rise in energy prices, and it seemed reasonable to expect that these prices would level out or even decline mildly, as built into futures prices. Unit labor costs were still being held down by moderate wage growth and rising productivity. Indeed, a few saw a distinct possibility of further positive productivity surprises, representing a downside risk to the inflation outlook. Moreover, the markup of prices over costs in nonfarm businesses remained quite high, and firms would likely be pressed by competition to absorb a portion of any step-up in the growth of unit labor costs, at least if that acceleration were limited in extent and duration. In addition, prices of many non-energy commodities had risen in recent weeks, but such inputs constituted a relatively small fraction of overall business costs, and, partly for that reason, in the past commodity prices had demonstrated little predictive content for broad inflation rates. While short-term inflation expectations had risen somewhat, longer-term inflation expectations remained well contained. And lastly, monetary policy would be aimed at preserving price stability.

During the monetary tightening cycles of the 1960s, 1970s, and 1980s, the Fed was fighting serious cyclical and structural inflation problems. During these fights, the Fed raised the federal funds rate to levels that triggered recessions, which knocked inflation down. The bull markets of those three decades lost those fights too. When the Fed raised interest rates during the mid-1990s, inflation wasn't enough of a problem to warrant triggering a recession. When investors figured that out, stocks soared. They might come to the same conclusion about the inflation issue today.

For stock investors, if a recession isn't likely any time soon, then the bull market should continue to be earnings driven as it has been since early 2003, when it began. S&P 500 forward earnings is up 38.6% since then, and I expect an increase of 12% this year and 6% next year.[1] Meanwhile the forward P/E is just about unchanged at 15.5 since the start of the bull market. The forward P/E tends to peak at about the same time as the Fed starts to raise interest rates. It *has* been different this time since the forward P/E was already down significantly when the Fed started to tighten in June 2004 (Figure 2).

Let's Get Real. I may be fighting the Fed, and that may be a big mistake. However, the federal funds rate is 2 ¾%. That's all it is. During the last Fed tightening cycle, the fed funds rate was 3% when the FOMC *started* to raise rates! I believe that the core inflation rate using the personal consumption deflator could remain between 1.5% and 2.0% through the end of the decade. If I am right then the cyclical peak in the federal funds rate should be 3.5% to 4.0%, assuming that a 2% real rate is the "right" real rate for the economy.

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[1] See "Globalization Is Profitable," March 22, 2005, http://www.yardeni.com/pub/a_050322.pdf.

A Beautiful Model. My Fed Models are confirming that a cyclical peak in the fed funds rate is likely before the end of this year. Debbie Johnson and I update these models monthly on the web site.[2] We have observed that monetary policy is strongly influenced by industrial commodity prices. The CRB raw industrials spot price index tends to lead or coincide with the federal funds rate target. This index is still rising, but it is probably close to peaking (Figure 3). The correlation between the federal funds rate target and the yearly percent change in the CRB metals spot price index is even more impressive. In early April, the metals index was up only 18.6% from a year ago compared to its latest cyclical peak of 62.1% during the week of April 6, 2004 (Figure 4).

Why do I believe that industrial prices are approaching a peak? That's what FRODOR continues to say. The year-over-year growth rate in foreign official dollar reserves—my favorite measure of global liquidity—continues to plunge. It was 14.2% in early April, down from a peak of 36.2% during the week of August 18, 2004. It leads industrial commodity prices by 52 weeks (Figures 5 and 6).

Why Is FRODOR Losing It? Why is the growth rate in global liquidity falling so rapidly? Perhaps, the Fed's tightening since June 2004 is already slowing the global economy faster than widely recognized. So while a peak in commodity prices and the fed funds rate should be bullish for stocks, maybe I am still on the wrong side if the Fed's tightening is about to really hurt global growth.

I don't think so. The question is: Why are central banks buying U.S. Treasury and Agency securities at a slower pace? The answer is that the Fed may have succeeded in convincing private foreign investors that the U.S. economy can continue to grow with low inflation and good investment returns, at least in dollar terms. So capital inflows are increasing sufficiently to offset the gigantic U.S. trade deficit, reducing the pressure on foreign central banks to prop up the dollar. Figures 7, 8, 9, and 10 support my hypothesis:

1) Over the past 12 months through January, the U.S. merchandise trade deficit widened to a record $663.8 billion. However, net securities purchased by foreigners in the United States totaled $830.0 billion over this period (Figure 7).

2) On a year-over-year basis, FRODOR (central bank purchases of U.S. Treasuries and Agencies), peaked at $330 billion during August 2004. It fell to $227 billion in March of this year. Net securities purchased by *private* foreign investors rose to a record $591 billion in the 12 months through January (Figure 8).

3) When the U.S. trade deficit exceeds net securities purchased by private foreigners in the U.S., the dollar tends to be weak. When these net purchases exceed the deficit, the dollar tends to be strong (Figures 9 and 10).

[2] See "Fed Watcher," http://www.yardeni.com/pub/fw.pdf.

The bottom line is that a slowing in central bank purchases of U.S. Govis is bullish, not bearish for the dollar (Figure 11). Given the size of the U.S. twin deficits this is certainly a contrary view. Technically, the jury is still out, but a decision may be imminent. The dollar has rebounded in recent days back to its 200-day moving averages on a trade-weighted basis as well as relative to the euro, yen, and gold (Figure 12).

Time To Overweight Financials? So, if the fed funds rate is likely to peak before the end of this year at a level that won't risk causing a recession and if inflation remains low, then is it time to overweight Financials? They certainly could do better, but I am inclined to underweight this sector primarily because it is so overweighted now in the market. Financials account for 20% of the market capitalization of the S&P 500. That's high, but not excessive since the earnings of this sector account for more than 25% of corporate profits. However, the earnings' share seems to have peaked a year or two ago, and is likely to continue to decline as regulators continue to come down hard on some of the accounting practices that may have artificially boosted earnings in the past (Figures 13, 14, and 15).

Another negative for Financials is that the yield curve might continue to flatten as the Fed hikes the federal funds rate three or four more times in "measured" steps, while the 10-year Treasury yield remains stuck just north of 4% (Figure 16). While the forward earnings of Financials may be depressed by a flatter yield curve, they could get a lift from improving credit quality (Figure 17).

Analysts covering Financials are less inclined to see them as growth stocks. Since 1995, 12-month forward consensus expected earnings growth of S&P 500 Financials exceeded the comparable forecasts for the S&P 500, with only one exception during most of 2001. Now, they are the same (Figures 18, 19, and 20).

In any event, the Financials with the best forward earnings momentum are Consumer Finance, Multi-Line Insurance, and Life & Health Insurance (Figures 21 and 22).

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PREMIUM SERVICE

On May 1, Dr. Ed will offer a fee-based Premium Service. It is designed for top Institutional Investors and will include:

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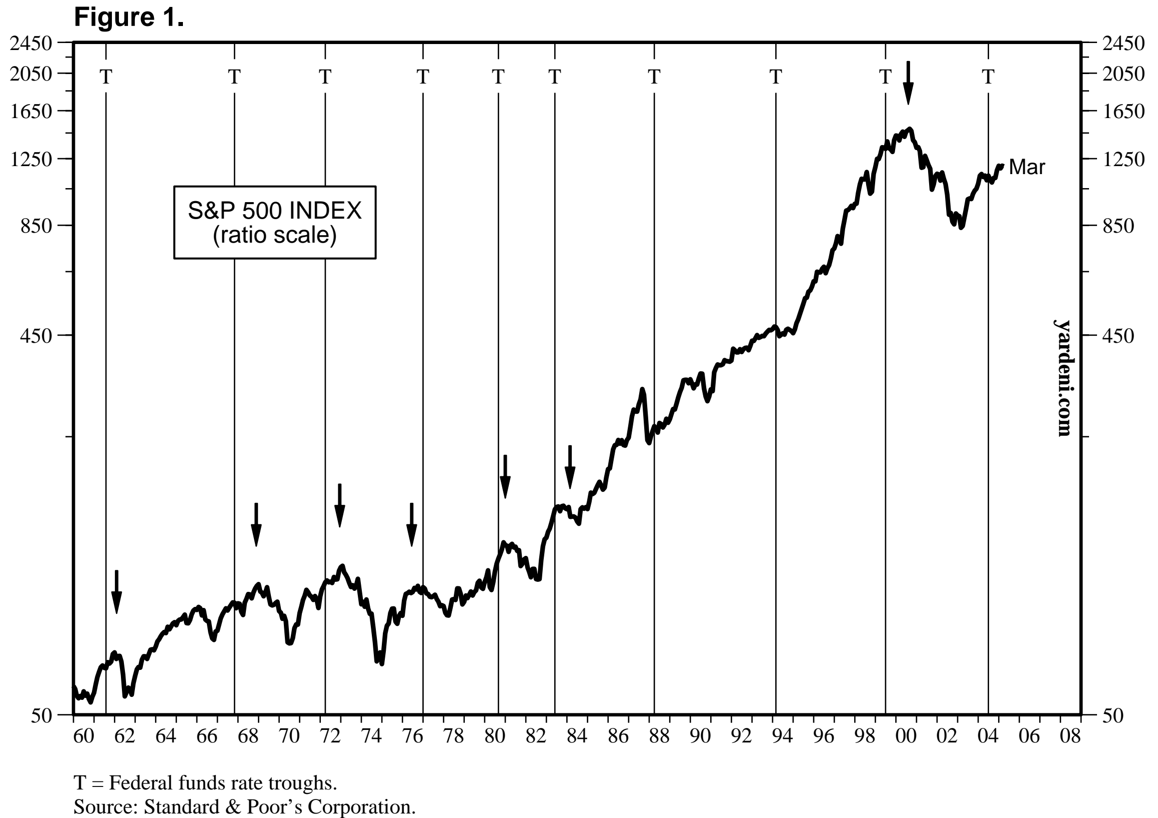
- Access to the latest editions of Dr. Ed's commentaries, studies, alerts, chart books, and handbooks. The latest versions will no longer be available to the public.
- A customized section of your page with charts, presentations, and reports designed just for you by our staff.
- Regular email updates (with occasional movie reviews, of course).
- Regular conference calls with Dr. Ed.
- Regular meetings in your office with Dr. Ed.
- Regular lunches with Dr. Ed in major cities around the world.

To learn more about Dr. Ed's Premium Service, send an email to yardeni_requests@oakassociates.com with your name and phone number. One of our service advisors will contact you.

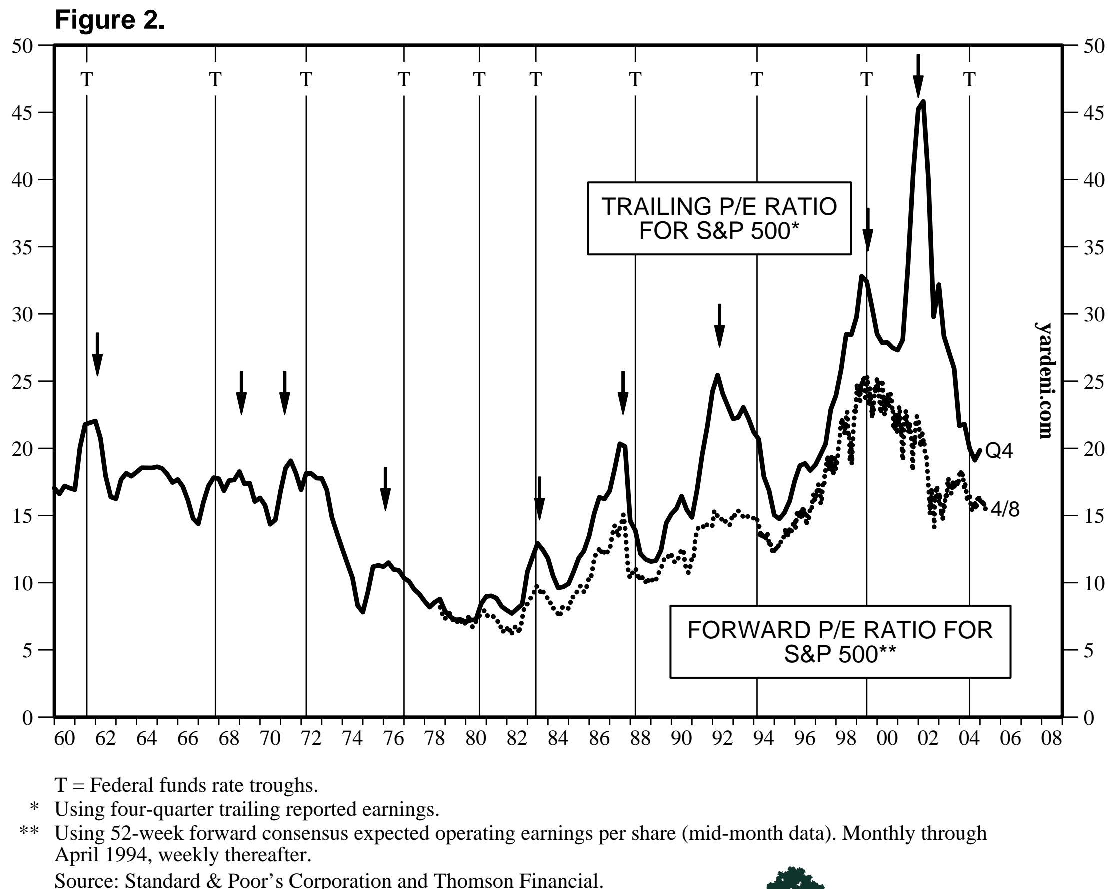
- Fed Funds Rate & S&P 500 -

During the inflation-challenged 1960s, 1970s, and 1980s, S&P 500 tended to peak a few months after the Fed started to tighten. The market stalled for 11 months after the February 1994 rate hike, but then soared over the rest of the decade. The late-1999 hike was followed by a crash. The Fed started raising rates again during June 2004, or 10 months ago. Yet, the market remains on an uptrend.



T = Federal funds rate troughs.
Source: Standard & Poor's Corporation.

Market's trailing P/E often peaks either just before or just after the Fed starts to tighten. Forward P/E tends to peak at about the same time as fed funds rate bottoms. This time, the P/E has been relatively flat as the Fed raised rates because it had already dropped sharply from 1999-2002.

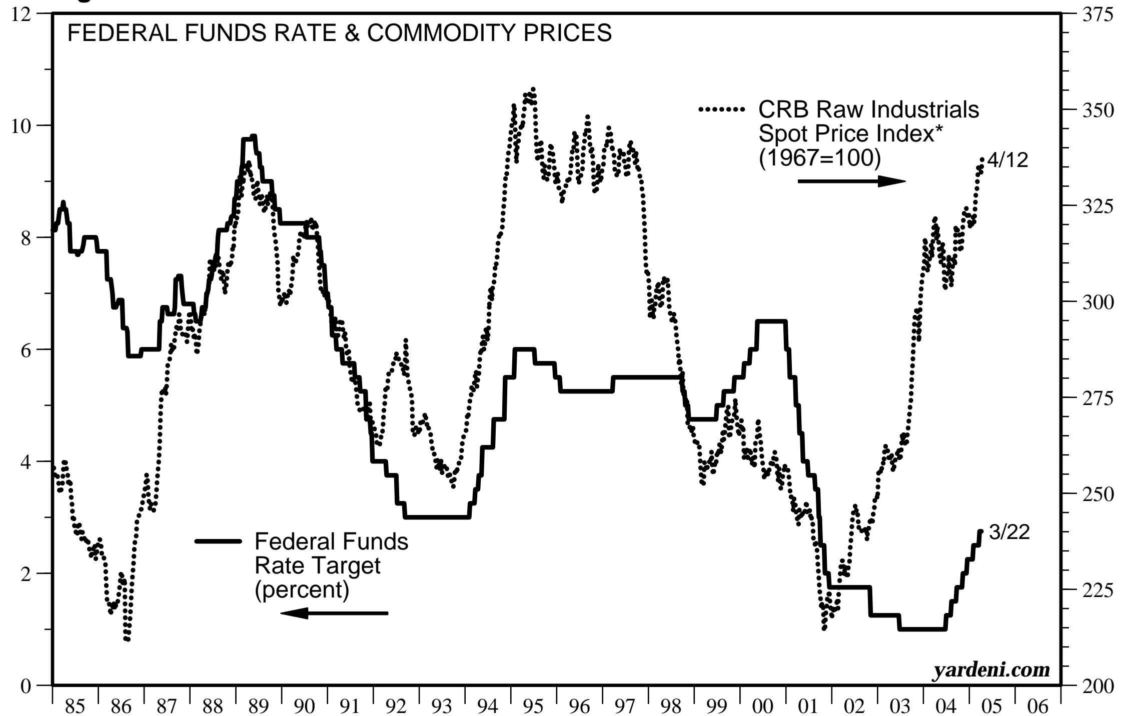


T = Federal funds rate troughs.
* Using four-quarter trailing reported earnings.
** Using 52-week forward consensus expected operating earnings per share (mid-month data). Monthly through April 1994, weekly thereafter.
Source: Standard & Poor's Corporation and Thomson Financial.

- Fed Funds Rate Models -

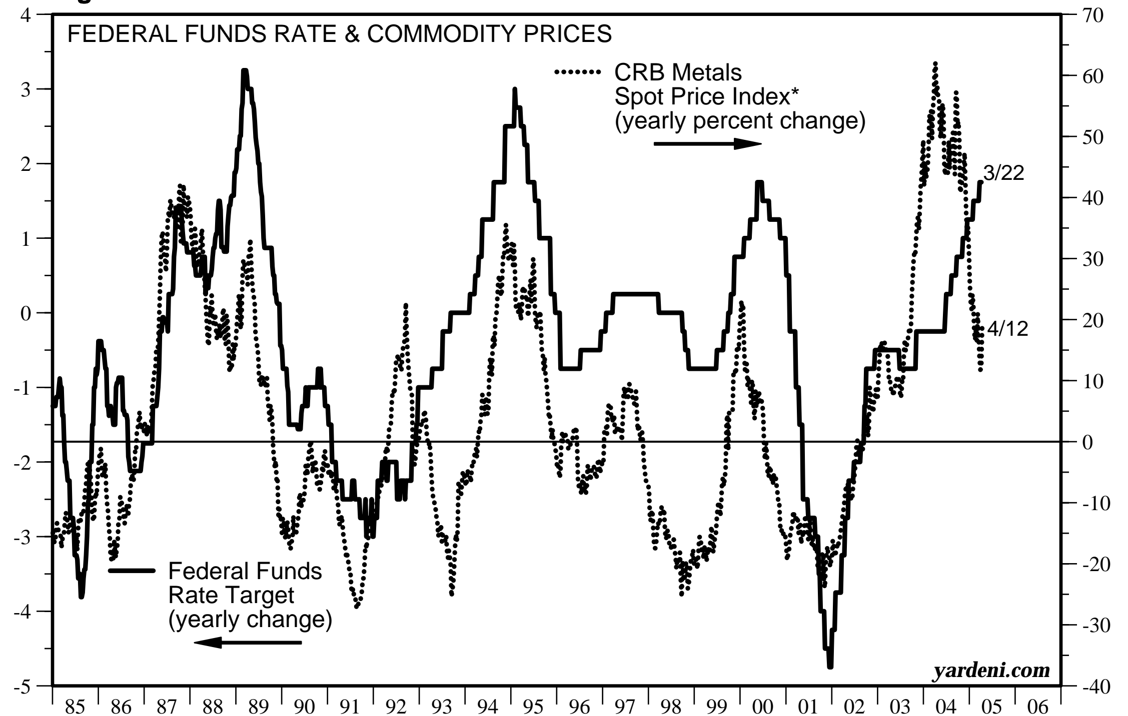
Fed policy is strongly influenced by industrial commodity prices, which seem to have peaked on a year-over-year-percent change basis. This implies that the Fed's tightening cycle should end soon.

Figure 3.



* Includes copper scrap, lead scrap, steel, tin, zinc, burlap, cotton, print cloth, wool tops, hides, rosin, rubber, and tallow.
Source: Board of Governors of the Federal Reserve System and Commodity Research Bureau.

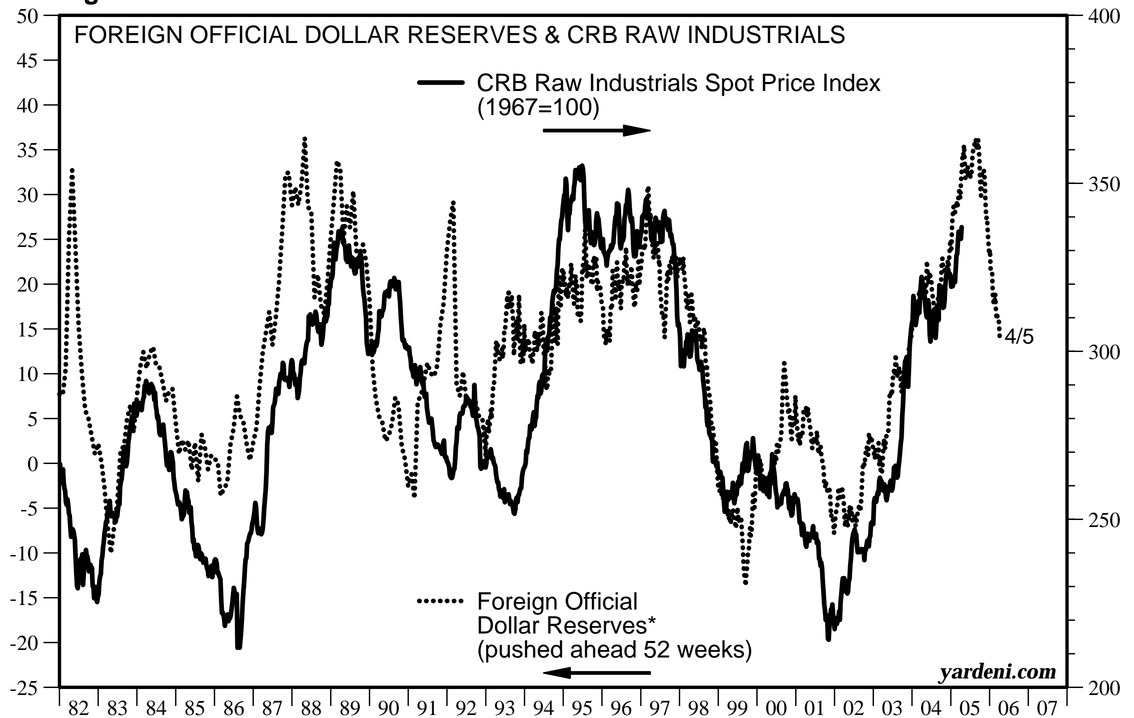
Figure 4.



* Includes copper scrap, lead scrap, steel scrap, tin, and zinc.
Source: Board of Governors of the Federal Reserve System and Commodity Research Bureau.

- FRODOR -

Figure 5.

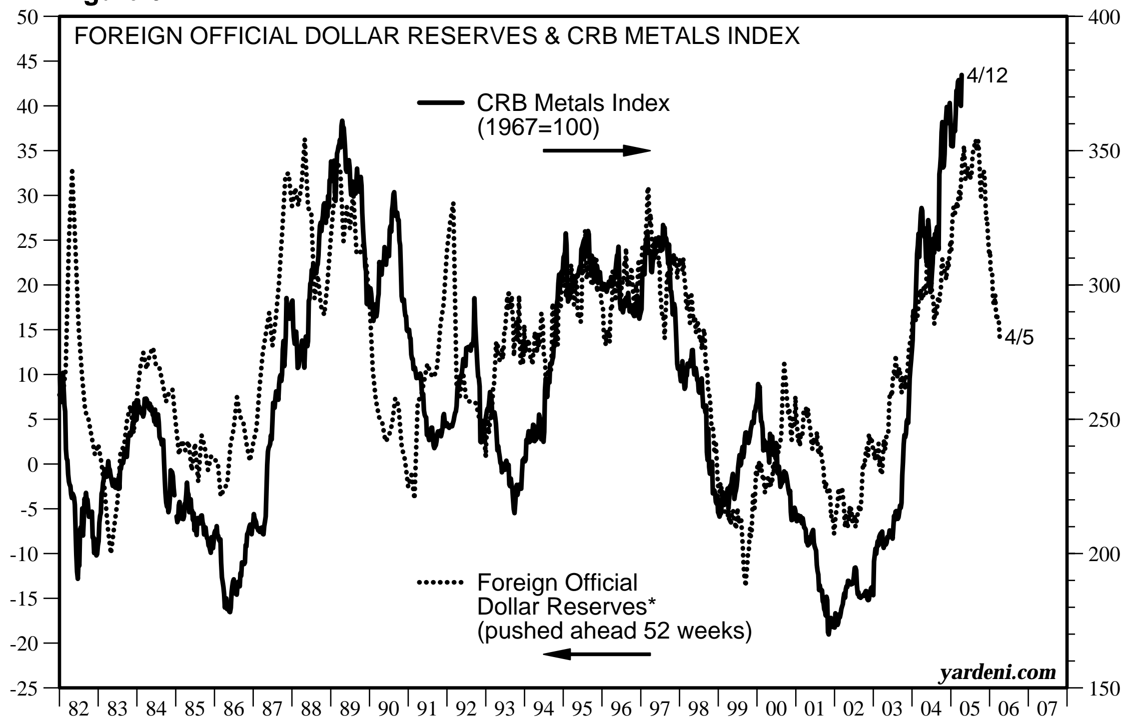


* Yearly percent change. U.S. marketable securities held in custody for foreign official and international accounts at the Fed. Monthly data from 1952 to 1990 include only U.S. Treasury securities. Weekly data from 1991 to 1999 include U.S. Treasuries. Weekly from 2000 on include U.S. Treasury and Federal agency securities.

Source: Board of Governors of the Federal Reserve System and Commodity Research Bureau.

The growth rate of FRODOR (a great measure of global liquidity) continues to decline significantly. It has been a great leading indicator of industrial commodity prices, and suggests that they should soon peak.

Figure 6.



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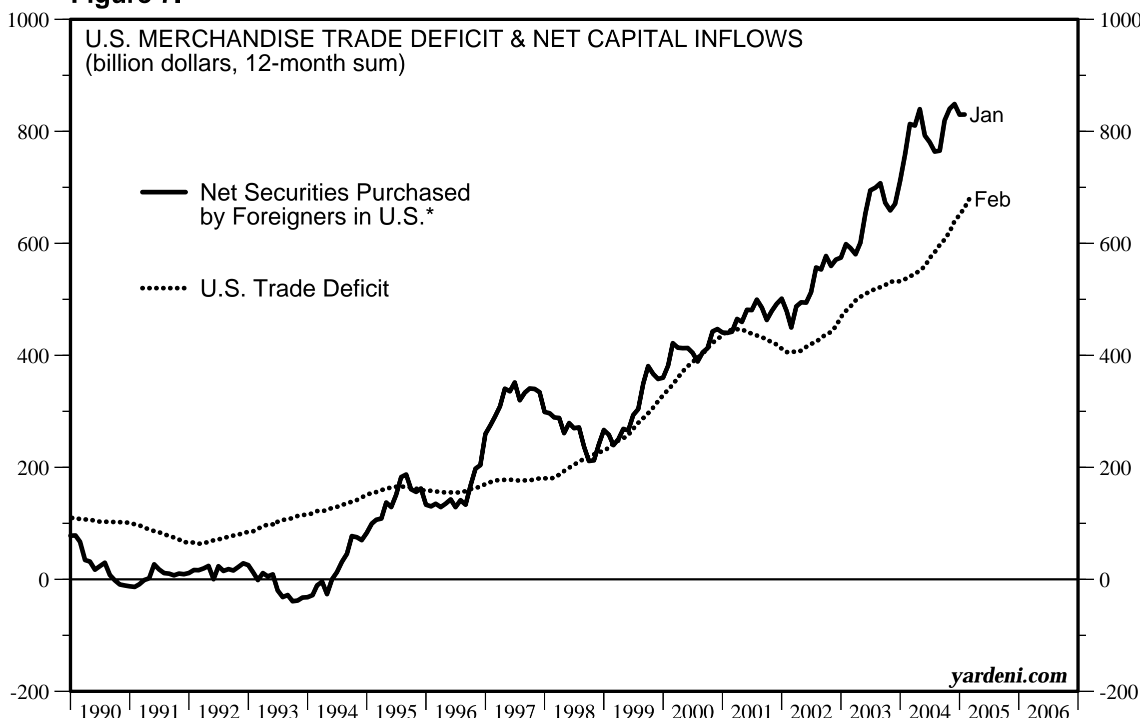
Source: Board of Governors of the Federal Reserve System and Commodity Research Bureau.

- Trade & Capital Flows -

Here's a positive spin: Huge U.S. trade deficit is stimulating the global economy. Foreigners are getting rich exporting to U.S. and putting some of their new wealth back into U.S.

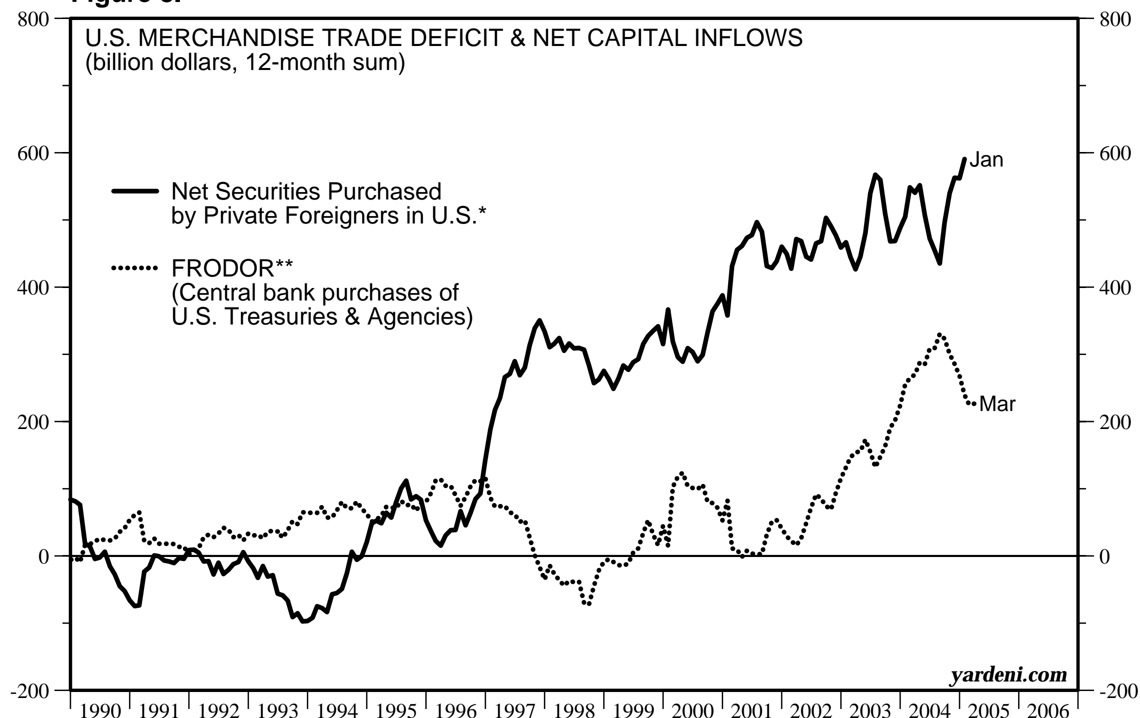
Figure 7.



* Includes Treasury bonds and notes, government agency bonds, U.S. corporate bonds, U.S. corporate stocks, foreign bonds, and foreign stocks.
Source: U.S. Treasury Department and Census Bureau.

Foreign central banks are buying U.S. Treasuries at slower pace as private foreign investors' pace of investing in U.S. picks up.

Figure 8.



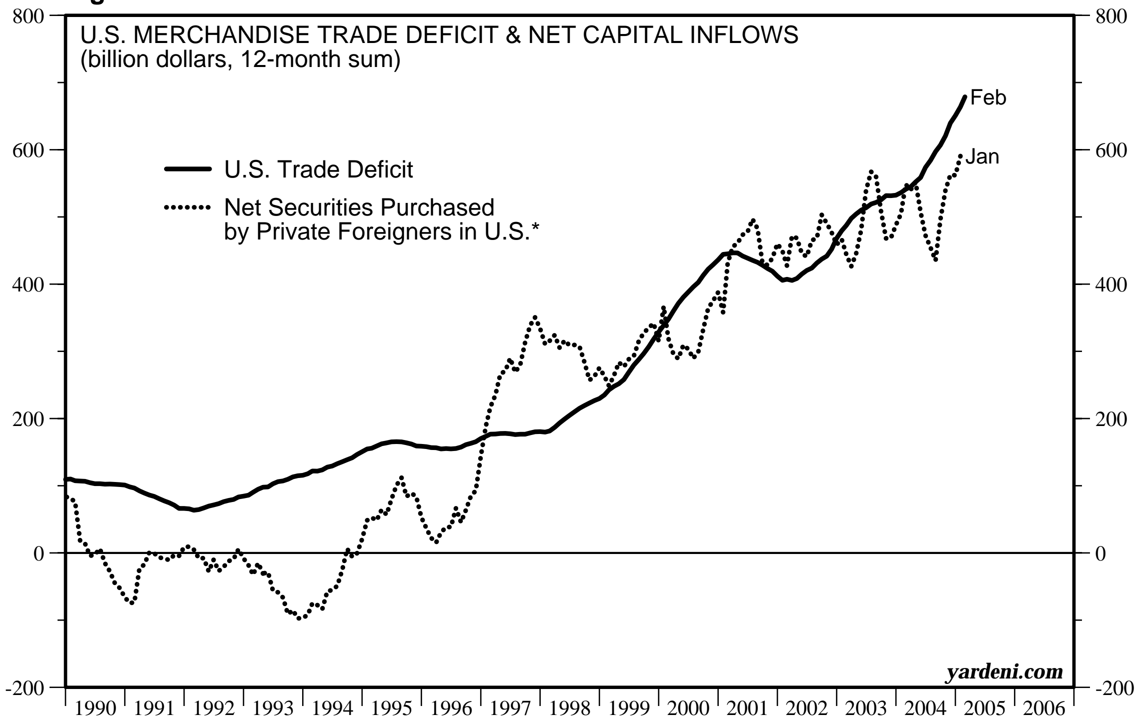
* Includes Treasury bonds and notes, government agency bonds, U.S. corporate bonds, U.S. corporate stocks, foreign bonds, and foreign stocks.

** Data from 1952 to 1996 are foreign official assets held at the Fed in U.S. Treasuries. From 1997 to the present, data are marketable U.S. Treasury securities held by the Fed for foreign and international accounts. Data from 2000 onward include federal agency securities. Source: U.S. Treasury Department and Board of Governors of the Federal Reserve System.

- Trade, Capital Flows, & the Dollar -

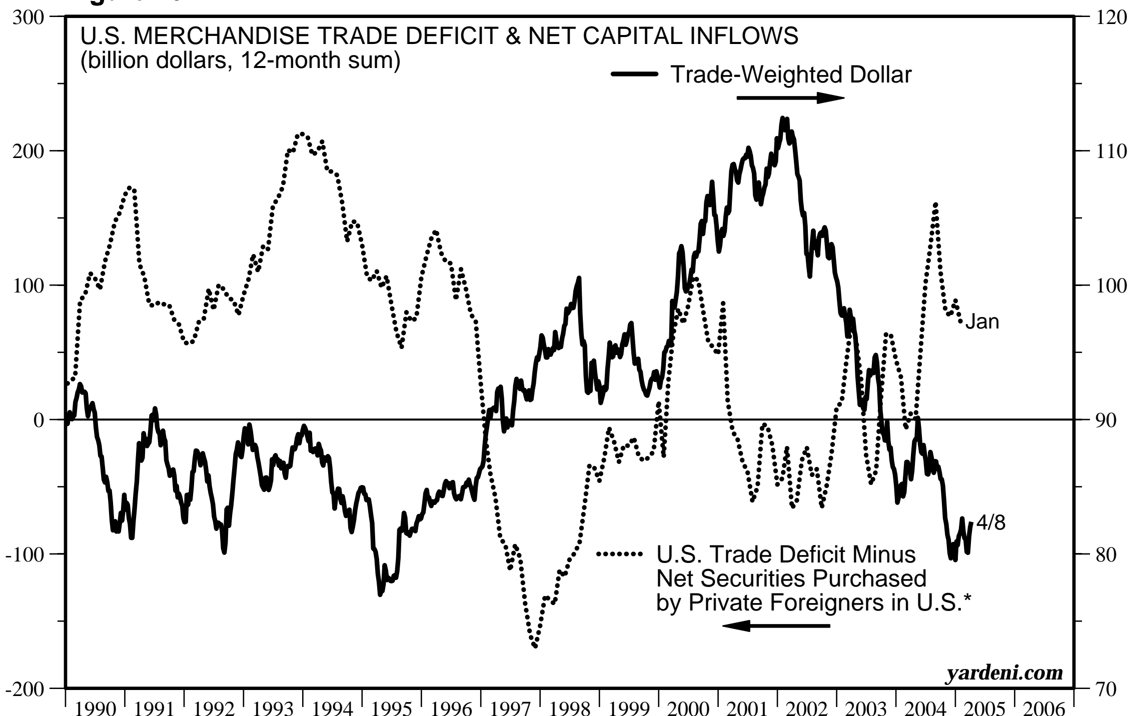
When U.S. trade deficit exceeds net securities purchased by private foreigners in U.S., the dollar tends to be weak. When these net purchases exceed the deficit, the dollar tends to be strong.

Figure 9.



* Includes Treasury bonds and notes, government agency bonds, U.S. corporate bonds, U.S. corporate stocks, foreign bonds, and foreign stocks.
Source: U.S. Treasury Department, Board of Governors of the Federal Reserve System, and Census Bureau.

Figure 10.



* Includes Treasury bonds and notes, government agency bonds, U.S. corporate bonds, U.S. corporate stocks, foreign bonds, and foreign stocks.
Source: U.S. Treasury Department, Board of Governors of the Federal Reserve System, and Census Bureau.

- FRODOR & Currencies -

Figure 11.

FOREIGN OFFICIAL DOLLAR RESERVES & THE DOLLAR
(yearly percent change)

FRODOR* 4/6
Trade-Weighted Dollar 4/8

FRODOR* 4/6
Euro/US $**

FRODOR* 4/6
Yen/US $

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* U.S. marketable securities held in custody for foreign official and international accounts at the Fed. Monthly data from 1952 to 1990 include only U.S. Treasury securities. Weekly data from 1991 to 1999 include U.S. Treasuries. Weekly from 2000 on include U.S. Treasury and Federal agency securities.

** On January 1, 1999, the euro was introduced. On that date, the exchange rates of the participating currencies were irrevocably set. Data prior to 1999 are derived from European currencies. Source: International Monetary Fund, International Financial Statistics and Board of Governors of the Federal Reserve System.

- U.S. Dollar & Gold -

Figure 12.

TRADE-WEIGHTED DOLLAR*
(daily, 1973=100)

200-day moving average

4/12

U.S. DOLLAR / EURO**
(daily, inverted scale)

4/13

YEN / U.S. DOLLAR
(daily)

4/12

GOLD PRICE
(daily, dollars per ounce)

4/13

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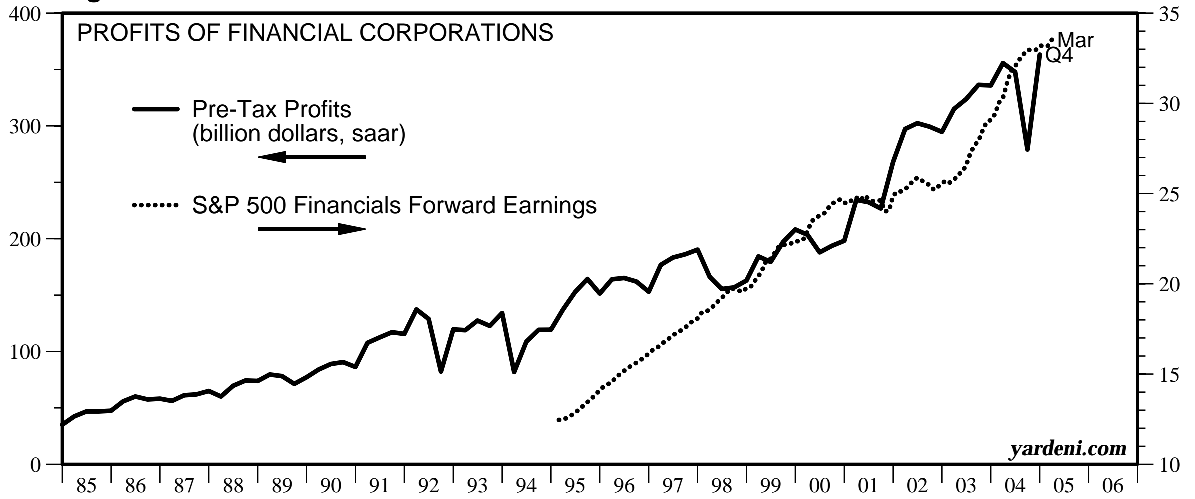
* Includes Switzerland, Germany, Japan, France, United Kingdom, Canada, Italy, the Netherlands, Belgium/Luxembourg, Sweden, Spain, Ireland, Austria, Finland, Portugal, and Australia.
** On January 1, 1999, the euro was introduced. On that date, the exchange rates of the participating currencies were irrevocably set. Data prior to 1999 are derived from European currencies.
Source: Board of Governors of the Federal Reserve System, Morgan Stanley Capital International, and Reuters America Inc.

- Financials Profits -

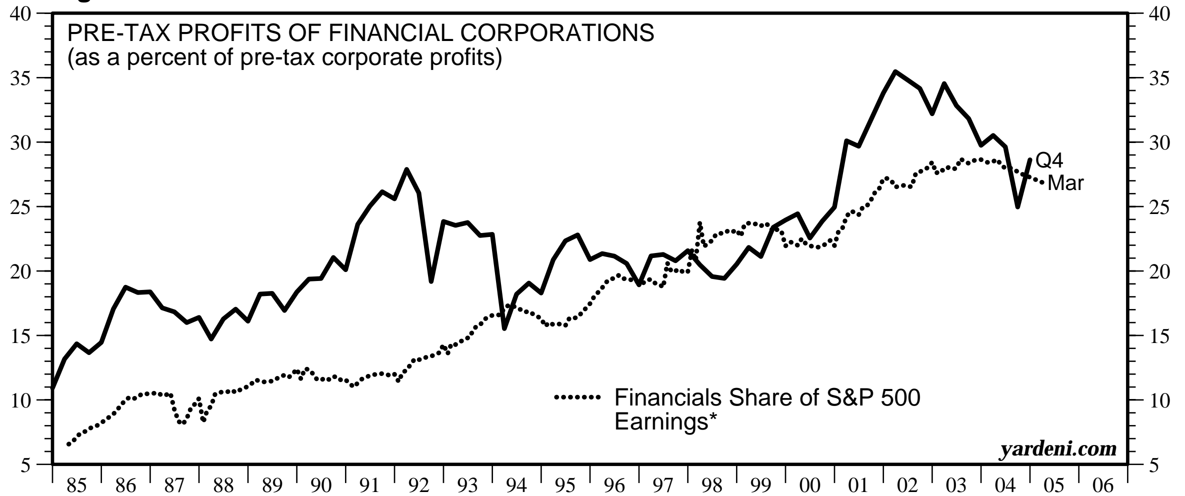
Earnings of financial corporations are on uptrend, but may be losing momentum.

Figure 13.



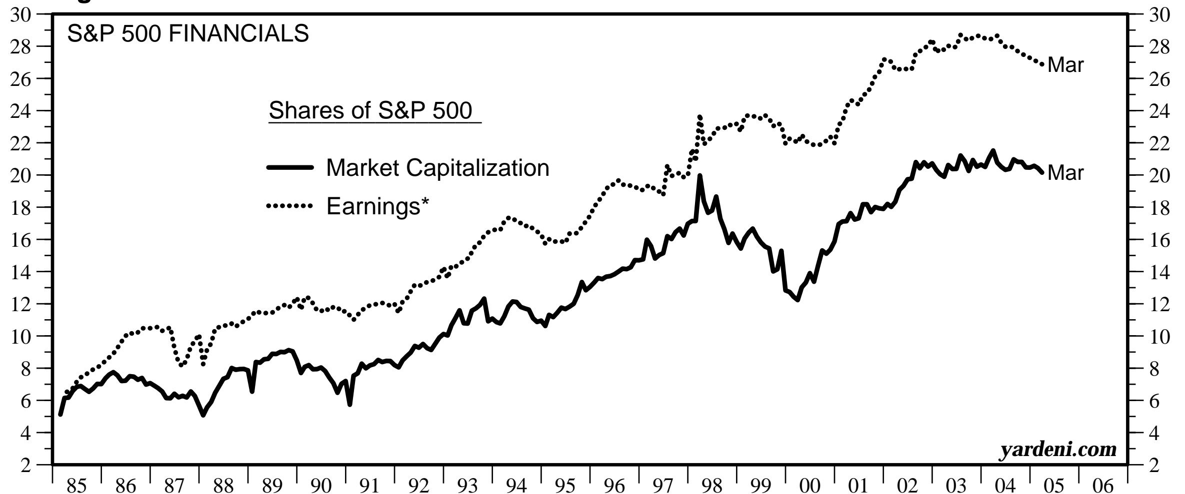
Financials' share of corporate profits peaked a year or two ago depending on the measure used.

Figure 14.



Financials' market share may be peaking now.

Figure 15.

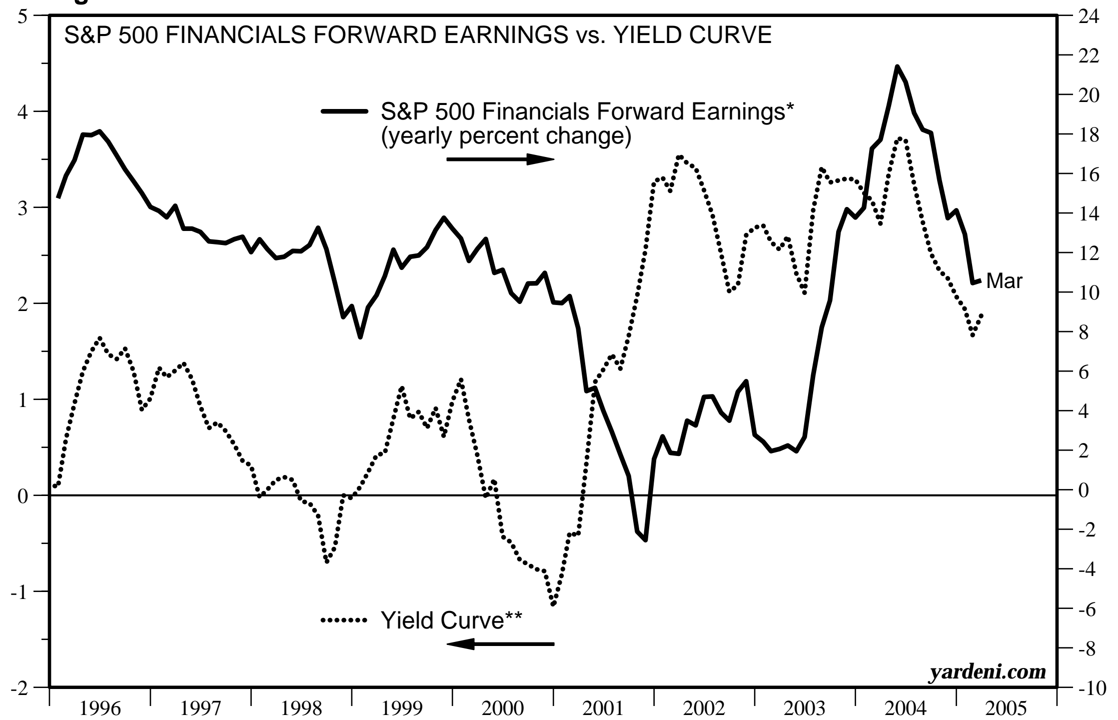


* Using consensus 12-month forward earnings forecasts.
Sources for all charts: U.S. Department of Commerce, Bureau of Economic Analysis, and Thomson Financial.

- Financials Earnings -

The flatter yield curve is a negative for Financials earnings.

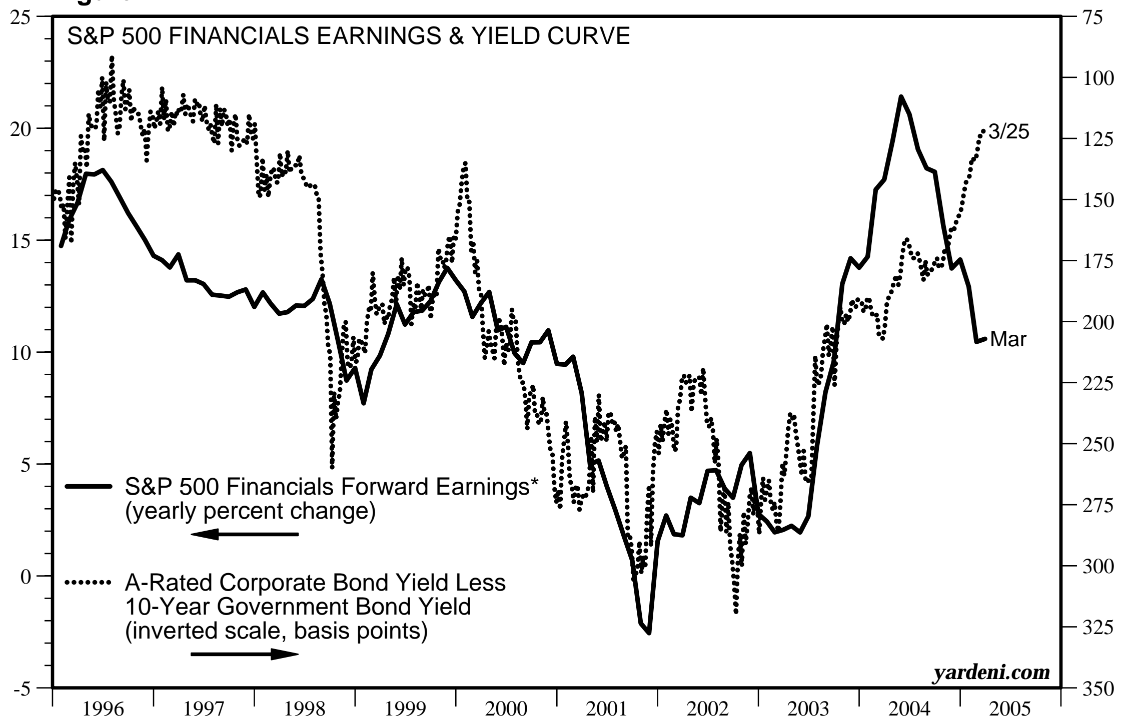
Figure 16.



* 12-month forward consensus expected operating earnings per share.
** 10-year Treasury yield less the Fed funds rate.
Source: Thomson Financial and the Board of Governors of the Federal Reserve System.

The narrow credit quality spread is a plus for Financials' earnings.

Figure 17.

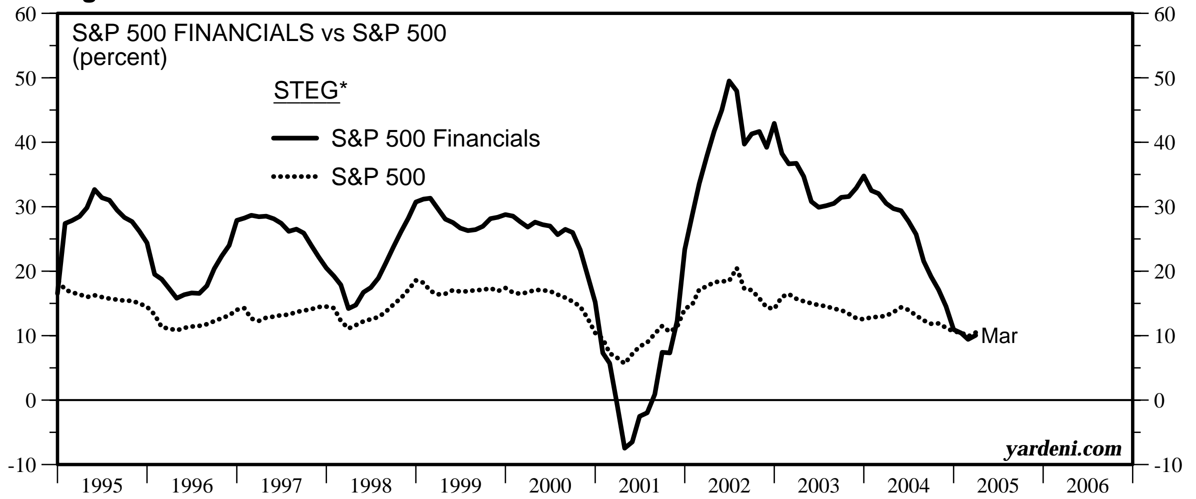


* 12-month forward consensus expected operating earnings per share. Time-weighted average of current and next year's consensus earnings estimates.
Source: Moody's Investors Service, Thomson Financial, and the Board of Governors of the Federal Reserve System.

- Financials Earnings Growth -

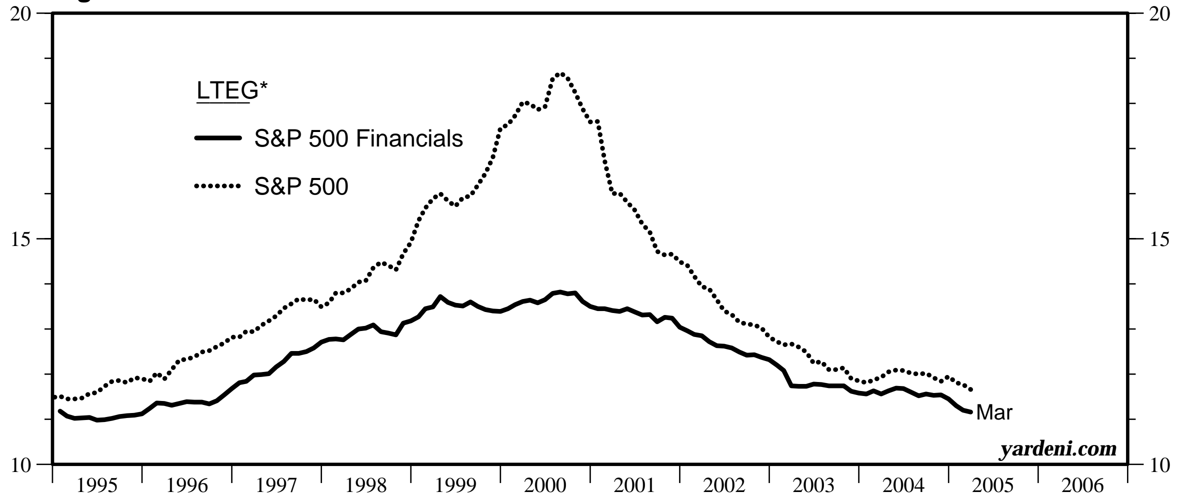
Over the short-term, earnings of S&P 500 Financials expected to grow at same pace as for overall S&P 500.

Figure 18.



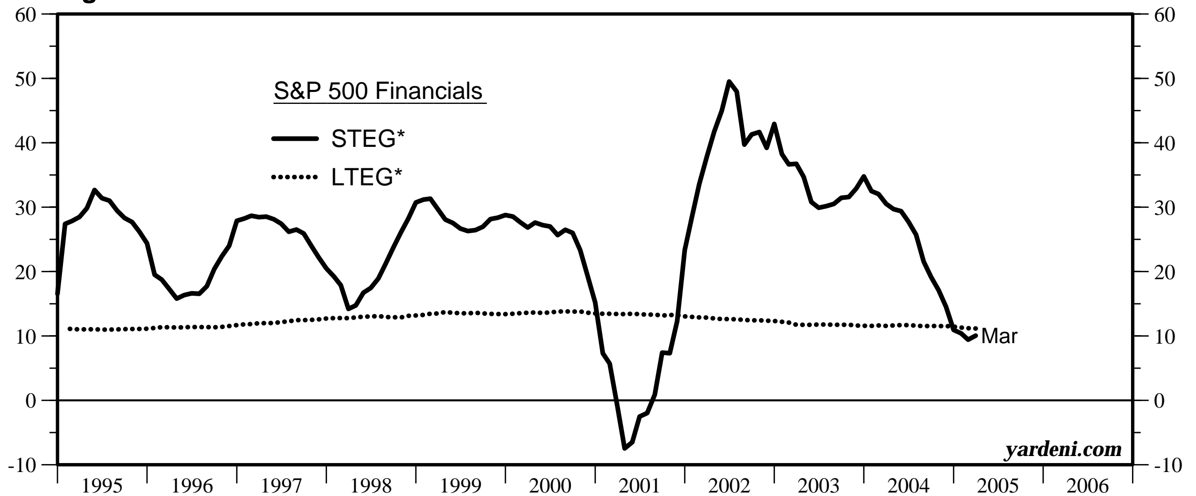
Expected long-term earnings growth for Financials is lowest since 1995.

Figure 19.



For Financials, STEG = LTEG currently.

Figure 20.

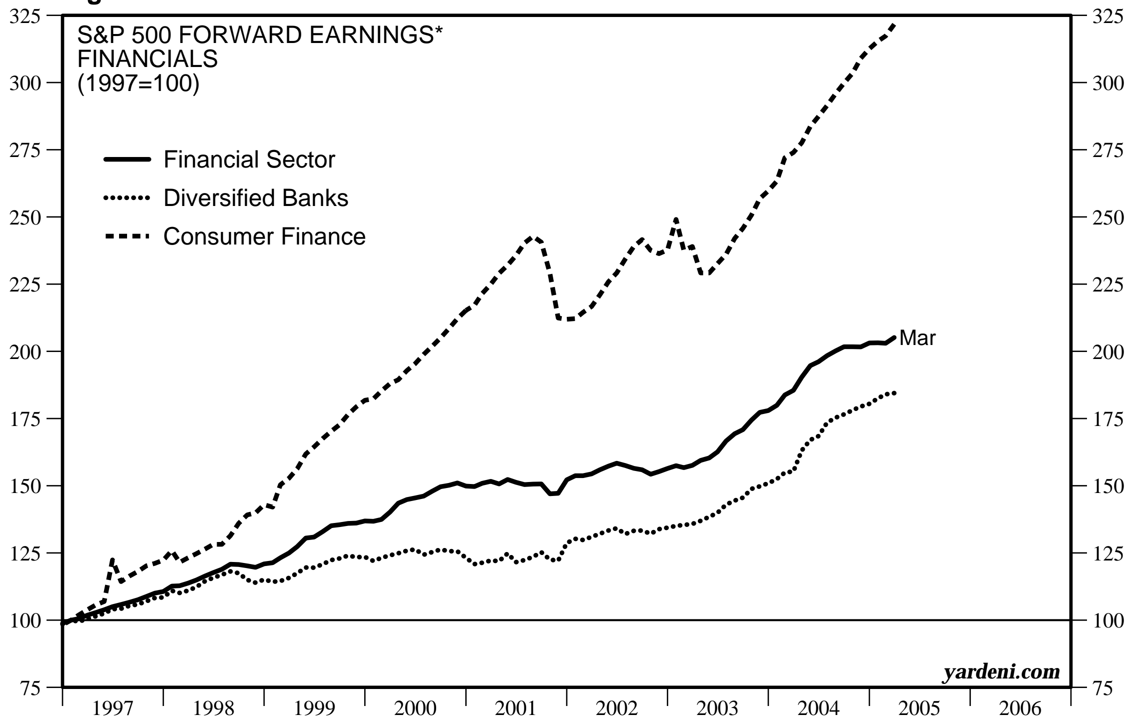


* Short-term earnings growth: 12-month forward consensus expected earnings growth.
Long-term earnings growth: 5-year forward consensus expected earnings growth.
Sources for all charts: Thomson Financial.

- Financials Relative Earnings -

Financial sector has lost its earnings momentum. However, Consumer Finance remains strong.

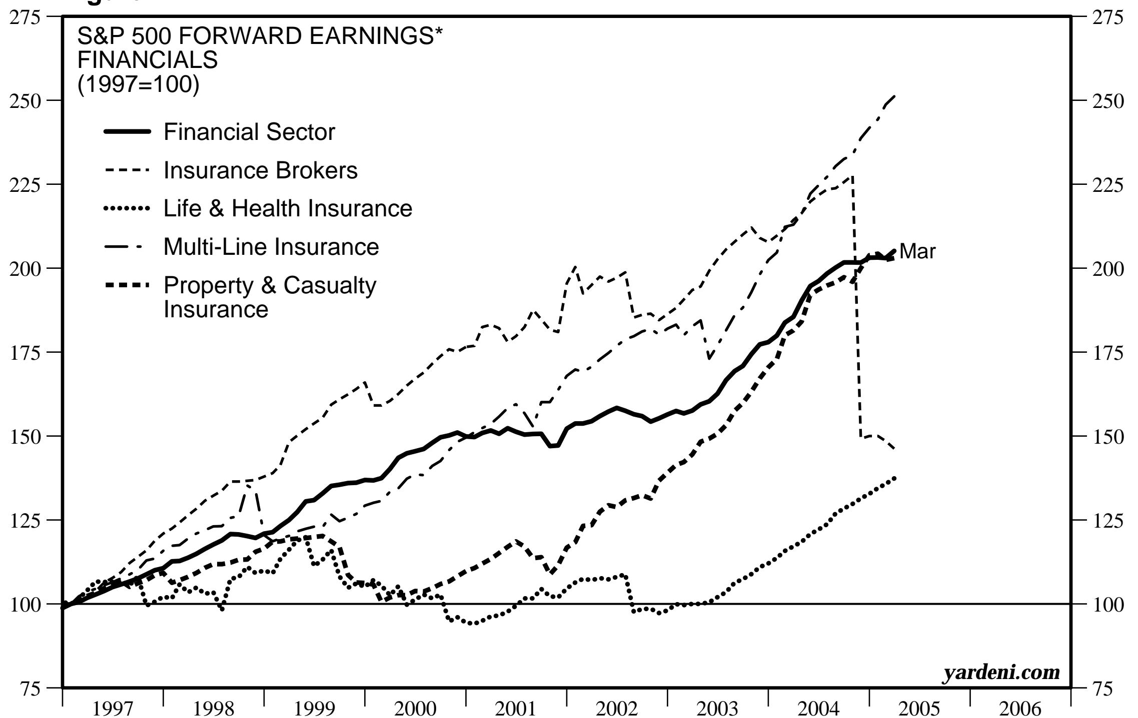
Figure 21.



* 12-month forward consensus expected operating earnings per share.
Source: Thomson Financial.

So do the forward earnings of Multi-Line and Life & Health Insurance.

Figure 22.



* 12-month forward consensus expected operating earnings per share.
Source: Thomson Financial.

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